GTE

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

October 8, 1996

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W. Room 222
Washington, D.C. 20554

EX PARTE: Federal-State Joint Board on Universal Service
CC Docket No. 96-45

Dear Mr. Caton:

On October 7, 1996, representatives of GTE Service Corporation met with the Honorable Sharon L. Nelson, Joint Board Commissioner and Chairman of the Washington Utilities and Transportation Commission, to discuss GTE's proposed auction mechanism for determining universal service support in the captioned docket. GTE used the attached materials in its presentation.

Please call me if you have any questions regarding this matter.

Sincerely,

Charon J. Harris

Attachment
cc: Federal State Joint Board Commissioners and Staff
J. Morabito

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JOINT BOARD

UNIVERSAL SERVICE BRIEFING

GTE

GTE Corporation
October 1996

The Regulatory Trilogy
▼ Key Messages ▼

A. Overall

- Unique opportunity: State and federal regulators have a unique opportunity to create the rules of telecom competition. Each of the major dockets in the "regulatory trilogy" — interconnection, universal service, access reform — must be addressed in its turn, without creating additional problems or revenue shortfalls to be resolved in the other proceedings. Regulators must proceed prudently with each proceeding; once they break open the egg of competition, unscrambling the result will be impossible.

B. Interconnection

- Unreasonable pricing standards: The FCC's interconnection order will diminish LECs' revenues that have helped support universal service. The FCC's unreasonably low pricing standard for unbundled network elements and high standard for wholesale discounts have not only eliminated any implicit support for universal service, but also have mortally weakened LECs' ability to compete. This has unnecessarily increased the problem that a new universal service fund is supposed to address. Unless the order is corrected to allow more reasonable pricing, the Joint Board's proposal will have to address the order's "gift" of LECs' assets to interexchange carriers, in addition to the needs of universal service.

- Undermining facilities-based competition: Consumers will not experience robust and widespread competition through alternate networks, since few competitors will be economically motivated to build them under the FCC's rules. (This will be even truer if universal service funding is inadequate.) By requiring LECs to sell parts of their networks to competitors at below-cost rates, the FCC's pricing rules make it cheaper for competitors to feed off of a LEC's network, rather than to construct their own facilities. This is parasitic competition, not real competition.

- Reduced customer choice: Consumers will be deprived of a major choice in retail local exchange services, since the FCC's rules relegate LECs to the role of wholesale operators. Competition will be muted given the LECs' inability to engage as robust competitors; they no longer can differentiate themselves from other entrants. Regulation, not market forces, will be determining customer choices.

- Continuing competition: A stay of the FCC's order will not delay the introduction of competition in the local market, since negotiations and arbitrations are proceeding, as contemplated by the Telecom Act.

- Exceeding statutory authority: The FCC has exceeded its authority under the Act in undermining the role of those who are closest to consumers — state commissions and carriers — in introducing local competition.

C. Universal Service

- Universal service goals: The goals of a universal service plan should be to ensure affordable, quality service in high-cost areas and to achieve rational pricing by transforming implicit support in current prices into explicit universal service funding. Support should be based on actual costs, not hypothetical, understated costs. Regulators should not succumb to political expedience in adopting a plan that only focuses on minimizing the size of a universal service fund. A universal service plan must be sufficient to attract continued telecom investment in high-cost communities.

- Comprehensive plan: To ensure the delivery of universal service to consumers, the Joint Board should recommend, and the FCC should adopt, a comprehensive universal service plan that addresses both interstate and intrastate aspects.

- Affordability: The federal plan should work together with state plans to ensure that the price consumers pay meets a national affordability objective. To maintain this price in a competitive market, it should establish a realistic compensation mechanism for Carriers of Last Resort (COLRs) that provide universal service.

- Price signals for competition: Universal service policy will set the price carriers see when they provide basic local service — the sum of the affordable price and the support. This must be set at the right level to send the correct price signals for market entry and investment in new technology.

- Funding: Funding should be through a competitively neutral end-user surcharge on all telecom retail services.

- Auction benefits: Once the initial cost-based funding level is determined, a competitive bidding process should be used to designate COLRs and determine support levels. This would replace the current debate over universal service cost with a market mechanism. Auctions would provide a means for correcting any errors in the initial cost-based support levels, and would adjust automatically over time to changes in cost, or in the basic service definition.

- COLR obligations: To ensure that all customers are served, support must be tied to a service obligation. But, unless all COLRs face the same obligations, competition will not coexist with a sustainable universal service plan. Consumers will be more likely to have a choice among service providers in high-cost areas if support is available to any carrier willing to undertake COLR responsibilities and successful in securing COLR status in an auction.

- <u>Statutory consistency</u>: The FCC and the states have the requisite authority under the Telecom Act to adopt and implement the provisions of GTE's universal service proposal.

II. Access Reform

- <u>Rational pricing benefits</u>: Consumers would benefit from a rational, economically efficient, uniform pricing structure for access charges, unbundled elements, resale, and local service. For example, the sum of prices for unbundled elements should reasonably resemble their bundled service equivalents. With such a pricing structure, competitors would receive correct price signals for market entry and for "make/buy" decisions, and help prevent "rate shopping."

- <u>Linkage to universal service</u>: Removing implicit support in existing access rates and transforming them into explicit support as required by the Telecom Act would help ensure continued delivery of universal service to consumers.

- <u>Need for flexibility</u>: Consumer needs would be better met if LECs have the same flexibility in pricing and packaging of access services as competing providers; and there no longer would be any justification for prescriptive access rules.

Impact of the Interconnection Order on GTE

This analysis reflects GTE's local and access service business as if it were being sold at the FCC's proxy prices specified in the order. It demonstrates the extreme wholesale discount when using proxy prices for the sale of network elements. This analysis excludes toll revenue, even though it will be indirectly impacted by unbundling, with reductions in contributions that currently support universal service. This is not a forecast of revenue losses or market share.

A. Nationwide (28 states)

Annual Revenues	Current	FCC Lower Limit	FCC Upper Limit
Local service (inc. SLC)	*3,910,803,000	3,218,877,000	3,385,886,000
Interstate access	592,671,000	105,314,000	188,530,000
Intrastate access	796,180,000	120,756,000	217,229,000
CMRS access	80,000,000	26,000,000	26,000,000
CCL/RIC (inter/intrastate)	1,827,113,000	0	0
Total	$7,206,767,000	$3,470,947,000	$3,817,645,000

B. Florida

Annual Revenues	Current	FCC Lower Limit	FCC Upper Limit
Local services (inc. SLC)	*456,752,000	365,575,000	385,491,000
Interstate access	67,566,000	13,291,000	24,981,000
Intrastate access	45,741,000	6,406,000	12,040,000
CMRS access	11,266,000	3,661,000	3,661,000
CCL/RIC (inter/intrastate)	234,180,000	0	0
Total	$815,505,000	$388,933,000	$426,173,000

C. Missouri

Annual Revenues	Current	FCC Lower Limit	FCC Upper Limit
Local services (inc. SLC)	*59,782,000	96,734,000	100,712,000
Interstate access	15,956,000	2,779,000	4,795,000
Intrastate access	34,332,000	3,353,000	5,785,000
CMRS access	1,028,000	334,000	334,000
CCL/RIC (inter/intrastate)	82,486,000	0	0
Total	$193,584,000	$103,200,000	$111,626,000

D. Washington

Annual Revenues	Current	FCC Lower Limit	FCC Upper Limit
Local services (inc. SLC)	*175,623,000	133,552,000	140,832,000
Interstate access	34,522,000	4,977,000	9,079,000
Intrastate access	28,235,000	4,326,000	7,886,000
CMRS access	3,827,000	1,243,000	1,243,000
CCL/RIC (inter/intrastate)	81,501,000	0	0
Total	$323,708,000	$144,098,000	159,040,000$

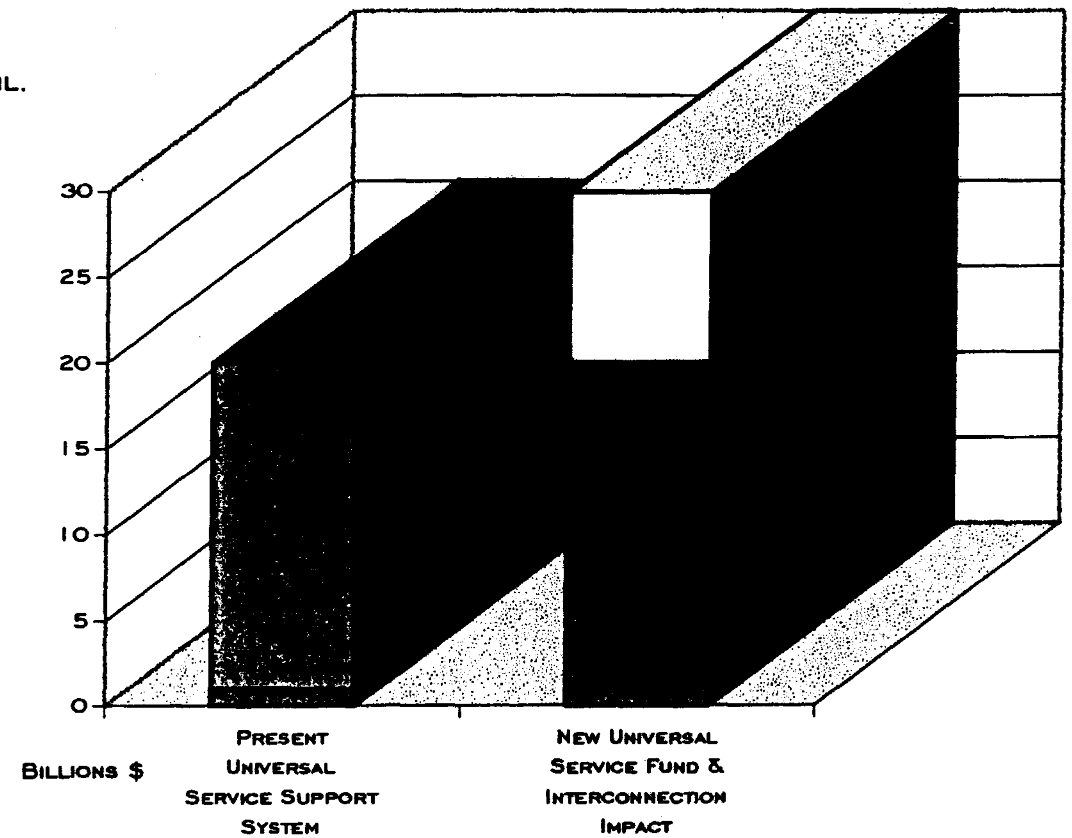
**Adjusted for avoided costs of 17% specified by FCC*

Interconnection order increases amount of funds needed to support universal service

PRESENT SYSTEM

EXPLICIT SUPPORT:
- HIGH-COST - $753 MIL.
- LIFELINE - $148 MIL.
- LINKUP - $19 MIL.

IMPLICIT SUPPORT:
(IN RATE STRUCTURE)
- $11-19 BIL.



NEW FUND

EXPLICIT SUPPORT:
- $12-20 BIL.

IMPLICIT SUPPORT:
- NONE

"GIFT" TO IXCS:
(INTERCONNECTION ORDER)
- $10 BIL.

Universal Service
GTE Proposal
October 1996

Key Element	Policy Objective	Present System	GTE Proposal
1. What is universal service?	• Provide affordable access to telecom services in all regions of the nation	• Voice grade access to public network • White page listing • Access to operator and directory assist. • Access to 911/E911	• Present service plus single party line and touch tone
2. How will universal service be funded?	• Develop specific, predictable, sufficient and competively-neutral funding mechanism that charges all telecom carriers	• Explicit charge to IXCs for USF • Implicit support in LEC rates (access, toll, business, vertical services)	• Surcharge on all retail telecom services (state and interstate) for new universal service fund
3. Who is eligible to compete for universal service support?	• Maximize competition by giving more carriers an opportunity to provide universal service	• Incumbent LECs	• Any carrier certified by state to be eligible to bid ("fitness" reqrmnt.) and receive support if successful
4. How will carriers be selected to receive support?	• Develop competitively neutral process to select universal service providers	• Incumbent LECs in own serving area	• Incumbent LECs initially; carriers then will bid for amount of support needed to provide universal service
5. What are the obligations of COLRs?	• Ensure that all consumers in high-cost areas have affordable service	• Incumbent LECs must provide service to customers in service areas	• COLRs must be prepared to provide defined service package to any customer in bidding area for 3 years
6. What area would be the basis for receiving support?	• Target support to areas that are most in need	• Existing study area (frozen as of 11/15/84); USF based on study area average costs	• Census block group (CBG) cost estimates allow targeting of support
7. What are the relevant costs of providing universal service?	• Align support levels with true costs	• Average total costs of subscriber loops	• Use cost model to allocate actual costs among CBGs within study area
8. How will low-income consumers afford universal service?	• Ensure that all consumers have universal service	• Lifeline and Link Up America programs	• Credit to offset consumer's bill (portable among COLR and non-COLR carriers)

GTE Universal Service Proposal

Auction Process

- *CLEC petitions state to hold auction for selected CBG(s)*
- *State qualifies bidders*
- *State holds auctions twice yearly*
- *State establishes maximum support rate*
- *Carriers within certain percent of lowest bid become COLRs*
- *Highest winning bid determines level of support for COLRs*
- *Winners have COLR obligations for set period (3-5 years)*

Census Block Groups (CBGs)

"A" High cost	"B" High cost
"C" Med. cost	"D" Low cost

•Market forces bid down amount of support over time

•States rebalance local rates or continue funding up to Affordability Threshold

Support Mechanism

CBG "A" (high cost)
- Federal fund to Support Threshold
- Federal & State funds to Affordability Threshold

Support Threshold
(set by FCC w/Joint Board input)

CBG "B" (high cost)
- Federal & State funds to Affordability Threshold

Affordability Threshold
(set by FCC w/Joint Board input)

CBG "C" (med. cost)
- State fund to Local Rate

Local Rate
(set by State)

CBG "D" (low cost)
- No support required

•Two thresholds give FCC/States greater control over size & distribution of funds

•Actual costs distributed among CBGs help assure "explicit and sufficient" universal service support

How Bureaucrats Rewrite Laws

BY JOHN J. DIIULIO JR.

As the historic 104th Congress draws to a close, scholars have already begun to debate its legislative record. Some stress that the first Republican Congress in four decades enacted fewer major laws than any Congress since the end of World War II. Others respond that it was only natural that a new conservative Congress committed to restraining the post-New Deal rise of national government activism would pass fewer big-government bills. Likewise, while some interpret President Clinton's bright re-election prospects as a negative referendum on the GOP-led House and Senate, others focus on how Republicans ended up setting the agenda on everything from balancing the budget to welfare reform.

For at least two reasons, however, both sides in this early war over the 104th's history are firing intellectual blanks. One reason is that it is not yet clear how much of the legislation will stick politically. For example, Mr. Clinton has made plain that, if reelected, he plans to "fix" the new welfare law. And should the House fall to the Democrats, ultraliberal committee chairmen will move quickly to undo much of what the Republicans did legislatively on welfare, crime, immigration and more.

The other and more fundamental reason is that, no matter what happens in November, it is by no means certain that the laws passed by the Republican Congress over the last two years will survive administratively.

Bureaucratic Wars

Victories won on the legislative battlefield are routinely lost in the fog of bureaucratic wars over what the laws mean and how best to implement them. One of many recent examples is how the Federal Communications Commission has already virtually rewritten the Telecommunications Act of 1996.

On Feb. 8, President Clinton signed the first major rewrite of telecommunications law in 62 years. To many observers, the act represented the culmination of a series of political and judicial decisions that began in 1974 when the U.S. Justice Department filed an antitrust suit against AT&T, leading to a breakup of the old telephone monopoly and the creation in 1984 of the seven regional "Baby Bells." The bill-signing ceremony, the first ever held at the Library of Congress, was draped in symbolism. The president signed the bill with a digital pen that put his signature on the Internet. On a TV screen, comedian Lily Tomlin played her classic telephone company operator Ernestine, opening her skit with "one gigabyte" instead of "one ringie-dingie."

During the debate over the bill and for weeks after its enactment, the press played up the law's social-policy side-

The FCC's rushed, revanchist rewrite of the telecommunications law is based on a hypothetical pricing scheme that only an armchair economist could love.

shows, like the requirement that most new television sets contain a "V-chip" enabling parents to lock out programs deemed inappropriate for children. But its true significance lay in removing barriers to competition in the telecommunications industry, and devolving responsibility for remaining regulation to the states. While its language is often technical, you need not be a telecom junkie to understand the letter of the law or the record of floor debates in Congress.

For example, Sections 251 and 252 of the law promote competition in local telephone markets, expressly giving state commissions authority to decide, via a strictly localized, case-specific process, what constitutes "just and reasonable" rates. It affords the FCC no role whatsoever in setting local exchange prices: "Nothing in this chapter shall be construed to apply or to give the Commission jurisdiction with respect to . . . charges, classifications, practices, facilities, or regulations for or in connection with intrastate communication service."

The law's devolutionary language and deregulatory intent was so clear that groups such as the National Council of Governors' Advisors quickly produced reports advising key state and local decision makers to prepare for "telewars in the states." Soon, one NCGA report on the law explained, "governors' offices, state legislatures and state public utility commissioners will be drawn into state debates on how to ensure a 'level playing field for competition' among those firms seeking to provide local and intrastate telephone service." The major battles, the NCGA predicted, would be over the terms of price and interconnection agreements. Telephone company rivals could be expected to lobby governors, utility commissions and state legislatures in search of allies.

But within six months of the law's enactment, the FCC declared a victor in the "telewars in the states"—namely, itself.

The commission produced a 600-page document promulgating preasumptive national pricing standards in local telephone markets. The FCC insists that the order is necessary to pry open local markets to long-distance carriers like AT&T, small firms like Teleport, and cable and wireless companies. Otherwise, the commission asserts, incumbent local carriers like the Regional Bell Operating Companies will remain invulnerable to real competition as potential entrants to intrastate markets are forced to contend with 50 different, localized state regulatory regimes.

But the FCC's rushed, revanchist rewrite of the telecommunications law is based on a hypothetical pricing scheme that only an armchair economist could love. In its hundreds of pages of national regulatory dictates, the FCC almost completely ignores the actual costs that local companies incurred to create the system, and the regional and other variations in how they operate.

On Aug. 28, GTE Corp. and Southern New England Telephone Co. jointly challenged the FCC in court, arguing that the FCC's order constitutes an uncompensated taking under the Fifth Amendment by requiring them to sell their services at below actual costs. The order, they claim, would almost certainly enervate competition by permitting long-distance giants like AT&T to buy up local phone networks at huge discounts—an ironic potential outcome indeed given how all this began in 1974. Moreover, not only giants like AT&T but fly-by-night arbitrage artists could enrich themselves at the expense of consumers on the spread between actual operating costs and the prices set by the FCC. In response to the suit, a federal appeals court ordered a temporary stay of the FCC regulations and will hear oral arguments in the case tomorrow.

At a recent press conference, GTE's senior vice president and general counsel, former U.S. Attorney General William P. Barr, demanded to know why the FCC believes that it is better at making decisions "for 50 states than the state commissions are, who have done this historically, who have all the data that are relevant to the state before them."

A Mockery

But whether or not the FCC is wiser than the states, and regardless of who is right about the economics of the case, the FCC bureaucrats' order mocks key provisions of a democratically enacted law. The FCC's action is at odds not only with the textbook understanding of "how a bill becomes law," but with the first principles of limited government and American constitutionalism.

The FCC's action should serve to remind us that the devolution and deregulation of federal authority are always in the administrative details. On telecommunications, welfare, and almost every other major issue, big government is the administrative state in which judges and unelected officials, and not the elected representatives who debate and enact the laws, govern us all.

Mr. DiIulio is professor of politics and public affairs at Princeton, director of the Brookings Center for Public Management and adjunct fellow at the Manhattan Institute.

GTE UNIVERSAL SERVICE PROPOSAL

▼ Outline ▼

▼ PURPOSE:

GTE's universal service proposal is designed to provide explicit support to carriers wherever necessary to support affordable rates and to low-income customers throughout the country, provide competing carriers access to high-cost funding on equivalent terms, and replace regulation with a sustainable and fair market mechanism.

▼ ESSENTIAL COMPONENTS:

I. Carrier Obligations

A. *Core Service Obligation*

Carriers must offer to any customer within a service area a technology-neutral basic service package, which would consist of:

1. Residence voice grade access to the network that provides the ability to place and receive calls, and access to long distance carriers of the customer's choice
2. Touch-tone service
3. Single-party service
4. Access to operator services and directory assistance
5. Access to emergency services (E911)
6. Standard white pages directory listing

B. *Carrier of Last Resort (COLR) Obligation*

Any carrier receiving high-cost support must be designated by that state as being a Carrier of Last Resort. Obligations established by each state, under broad federal guidelines, would include:

1. Provide the basic service package to any residence customer in a service area at a rate no higher than a state-established ceiling
2. Meet state qualifications
3. Meet minimum service quality standards adopted by state
4. Provide for interconnection and equal access
5. Make services available for resale at reasonable rates.

II. Plan Thresholds and Geographic Boundaries

A. *Affordability Threshold*

Joint Board and FCC should establish a monthly rate threshold for the basic service package, while the costs above the Affordability Threshold to provide such service would be considered high cost and funded by federal and state funds.

B. *Federal Support Threshold and State Fund*

The FCC, with advice from the Joint Board, should establish a monthly Federal Support Threshold (greater than the Affordability Threshold) above which the costs of providing the basic service package would be covered entirely by the federal jurisdiction. A combination of the state and federal funds would cover the difference between the Federal Support Threshold and the Affordability Threshold.

C. *Affordability Transition*

States should transition local service rates for the basic service package up to the Affordability Threshold or cost, whichever is less, or create independent state mechanisms under Section 254(f) to hold prices below that threshold.

D. *Bidding/Geographic Area*

For the geographic area in which eligible COLRs will assume their obligations and receive high-cost funding assistance, GTE recommends using census block groups (CBGs). CBGs can be subdivided when necessary to accommodate existing service areas.

III. Support Calculation/Distribution

Day 1

1. Incumbent LECs' actual costs of providing basic service package assigned directly or distributed by a cost model to serving areas.
2. Funding provided to LECs for each customer served based on the difference between the per customer actual cost within a CBG and the rate ceiling.

Day 2+

1. Entrants notify the state of intent to bid for carrier of last resort duties and funding.
2. Competitive bidding conducted for each bidding area for which an intent to bid is submitted.
3. Bids would be the amount of per-customer monthly support required by the submitting carrier.
4. Funding provided to all carriers selected through the bidding process.

IV. Distribution of Funding

Day 1:

1. To any eligible carrier successfully bidding to provide service as a COLR for each subscriber who chooses that carrier.
2. To any carrier serving individuals eligible for income-based support.

Day 2+:

1. For each subscriber, to any eligible carrier successfully bidding to provide service as a carrier of last resort.
2. To any carrier serving individuals eligible for income-based support.

I. Funding Sources

A. *Federal Contribution to High-Cost Funding*
Uniform surcharge on interstate and intrastate telecom retail revenue of interstate service providers.

B. *State Contribution to High-Cost Funding*
Competitively-neutral state sources, such as surcharge on in-state (originating and terminating traffic) telecom retail revenue of intrastate service providers.

C. *Income-based Support Funding*
Uniform surcharge on interstate telecom retail revenue of service providers. For federal Lifeline program, each state may adopt its own income-based support program.

II. Offsetting Rate Reductions

Incumbent LECs reduce current rates bearing implicit support by amounts equal to the new explicit support. Result is revenue-neutral implementation of a new explicit support mechanism. This corrects price distortions in other markets caused by the need to support local service.

III. Auction Mechanism

A. *Notification Procedure*
States conduct auctions twice each year, initially. Carriers may notify states 90 days in advance of each auction date as to which bidding areas they intend to bid.

B. *Auction Design Principles*
Create a competitive situation which will encourage aggressive bidding, and permit multiple service providers in high-cost areas.

C. *Auction Objectives*

1. Promote greatest possible benefits from competition.
2. Promote efficient provision of service at minimum cost.

D. *Auction Mechanism*

1. Single round, sealed bid.
2. Winners are those who bid within a certain percentage of the winning bid. More bids are accepted if bidding range is narrow; fewer are accepted if bids are far apart.
3. Support provided equal to the highest of the winning bids.
4. Winning bidders in the initial auction for a service area will bear COLR obligations for three years; in subsequent auctions, COLR obligations will extend for five years.
5. All bidders, and the incumbent LEC, may withdraw after results of the auction are disclosed, subject to financial penalty.
6. At least two bidders are required to hold an auction. If fewer than two bids remain after withdrawal, the auction will be canceled and support will be provided to the incumbent at Day 1 levels.

GTE Universal Service Proposal

▼ Detailed Description ▼

▼ Purpose:

GTE's universal service proposal is designed to provide explicit support to carriers wherever necessary to maintain affordable rates and to low-income customers throughout the country, provide competing carriers access to high-cost funding on equivalent terms, and replace regulation with a sustainable and fair market mechanism.

This is accomplished by determining the amount of support explicitly required by today's telephone companies for providing a basic universal service package at an affordable price, and providing those carriers with explicit support from a competitively-neutral fund for the costs of such services above the affordable rate. Other carriers interested in serving as carriers of last resort in reasonably-sized geographic areas would be free to indicate their interest in providing universal service on equivalent terms and also obtaining equivalent support monies by requesting that those areas be put up for competitive bid. A sealed-bid auction, designed to permit multiple carriers to "win," then would be conducted to determine the amount of universal service support that would be provided to all "winning" carriers in each market.

This paper describes GTE's proposal in greater detail, with the essential components that any universal service proposal must address. These include:

- *I. Carrier Obligations*
- *II. Plan Thresholds and Geographic Boundaries*
- *III. Calculation of Support Available in Each Area*
- *IV. Distribution of Funding*
- *V. Funding Sources*
- *VI. Off-setting Rate Reductions*
- *VII. Competitive Bidding Mechanism*

I. Carrier Obligations

To ensure competitive neutrality, all carriers that obtain high cost universal service support for a given geographic area must be subject to identical universal service obligations.

First, this will ensure that the services provided by each carrier meet minimum requirements determined by state regulators and expected by residential customers.

Second, specific obligations will ensure that funding is provided to all interested carriers in a manner that promotes competition. Some will not be able to have lessened responsibilities than others and receive the same amount of funding in a given area.

Third, specific obligations will permit the use of a simple auction mechanism where the only variable on which carriers will be bidding in the auction will be the amount of support required from the fund to provide the prescribed service in a given area. All other aspects of a carrier's decision (geographic area, term of service, universal service package definition, etc.) will have been specified in advance by state regulators according to broad Federal-State Joint Board guidelines.

A. Core Service Obligation

The Joint Board should recommend and the FCC should define the specific attributes of a universal service package. Any carrier interested in receiving universal service support should be required to provide this service to any customer within areas eligible for universal service support funding. The service definition should be technology neutral and be comprised of the following features:

1. *Residence voice grade access to the network which provides the ability to place and receive calls and access to long distance carriers of the customer's choice*
2. *Touch-tone service*
3. *Single-party service*
4. *Access to operator services and directory assistance*
5. *Access to emergency services (911/E911)*
6. *Standard white pages directory listing.*

Policy Rationale

Consumers, regulators, and carriers all benefit from a clear definition of the service that is desired to be universally available. Customers can expect availability of a basic service package throughout the country. Regulators can be sure that any carrier determined to be eligible will, at a minimum, provide consumers with a specified set of features and functions. Carriers will know what their service obligations are, so they can determine with greater certainty the costs of providing service in a given area before committing to do so. Each state would be free to add elements to this national definition and fund them through its own state program.

Legal Authority

Section 254(c) gives the FCC the authority, upon recommendation of the Joint Board, to establish which services shall be deemed part of universal service.

B. Carrier of Last Resort (COLR) Obligation

In general, COLR obligations should be consistent with those which the incumbent LECs face today. Because these requirements may vary among LECs, states, and serving areas, it is not possible, nor is it necessary, for a federal universal service plan to dictate specifics of the COLR obligation. However, any federal universal service plan should set forth minimum guidelines for state determination of uniform COLR requirements.

Any carrier receiving high-cost support must comply with the following obligations:

1. *Meet state qualifications*
2. *Provide the basic service package to any residence customer in a bidding area at a price no higher than the Affordability Threshold.*
3. *Serve as COLR for set period of time (3-5 years)*
4. *Meet state minimum service quality standards*
5. *Provide for interconnection and equal access*
6. *Make services available for resale at reasonable rates*

Under this approach the states would develop a two-step process. First the states would determine which carriers, among all those interested in providing universal service in a high-cost area, would be eligible to receive universal service support. Second, funding actually would be provided to those eligible carriers which agree to a minimum set of "carrier of last resort" obligations, consistent with federal guidelines. In particular, the federal guidelines would require that whatever obligations the state may establish for COLRs should be the same for all COLRs in a given area. Under GTE's proposal, these carriers would be self-selected through a competitive bidding mechanism. The following is a description of the minimum set of obligations a state should require of any carrier receiving universal service support.

1. *State qualifications*
   In order to ensure consumers receive continuing and reliable service from any carrier seeking to receive universal service funding support, states should develop a minimum set of criteria, in effect a set of "fitness" requirements. This could be a simple certification process as to a firm's financial capacity to meet the carrier of last resort obligations in a given market area.

2. *Provide the basic service package*
   This is described in the previous section. Each carrier receiving federal support would be required to provide to any customer requesting the universal service basic package, within a given area, the full complement of service features as defined by the Joint Board. The carrier must provide the basic service package at a price that does not exceed the Affordability Threshold set by regulators or the regulated local rate, whichever is less. The carrier would also meet any limits on terms and conditions established by the state.

3. *Serve as COLR for set period of time (3-5 years)*
   When an area is set for auction, the terms of the auction would require carriers to commit to serving all customers within a given market for a set period of time. The service obligation must also be designed to encourage carriers to invest in given market areas. Winning bidders in the initial auction for a service area will bear COLR obligations for three years; in subsequent auctions, COLR obligations will extend for five years.

4. *Minimum service quality standards*
To the extent that most states maintain quality requirements for carriers, these requirements should be spelled out for all carriers seeking federal universal service support. Encouraging the entry of new carriers to provide universal service should not result in the vitiation of regulators' service quality objectives. New service standards imposed on COLRs in high-cost areas may increase their costs and would trigger an auction to allow COLRs to determine the appropriate funding level.

5. *Provide for interconnection and equal access*
Carriers seeking to receive funding for supplying universal service must provide for access to long distance carriers of the customer's choice and permit other carriers to interconnect facilities. To the extent these requirements are not imposed on all carriers, progress made to date in implementing these policies will erode as new carriers gain customers and provide a lesser scope of services. Any reduction in interconnection and access also would hinder the development of competition, even from carriers not requiring support.

6. *Resell services*
Under GTE's proposal, resellers may enter markets as carriers of last resort. However, each COLR must be able to provide service to all customers in the area, regardless of how the COLR provisions the service. This responsibility must rest with the COLR and not with the underlying carrier. However, resellers would only be eligible for support monies if the price they pay for the resold facilities is not artificially constrained by regulation, but rather is established using a market-based mechanism. When a COLR is supplementing its own facilities by reselling facilities obtained at a constrained price, the underlying carrier should receive the universal service support for the customer served, not the reseller.

Policy Rationale

There is an inherent conflict between a functioning competitive market and the need to subsidize the costs of carriers which operate in certain high-cost areas. For there to be competition, more than one carrier needs to provide service. For these competitors to compete on equal footing, support provided to any carrier must be available to others on equal terms and conditions. Finally, the support must be provided in a manner which limits the amount of funding to a sufficient level.

Regardless of the method chosen to determine which carriers may receive universal service support funding, the ground rules for all carriers must be identical. One carrier should not receive more support for serving a customer than another if both are subject to the same service requirements. Similarly, one carrier should not be subject to more or fewer service obligations than another, given the same level of support. It would be extremely difficult to provide varying levels of support to carriers depending on different levels of obligations.

While the imposition of symmetrical COLR obligations should be applied under any type of universal service plan, it would be an essential component when using competitive bidding to determine support levels.

- First, carriers seeking universal service support must have something tangible upon which to bid. Just as vendors who bid on contracts from governments and businesses expect payment (in accordance with the bid) for services rendered, receipt of universal service support must also be tied to a clear obligation to perform a specific service.
- Second, if one bidder in the auction is unduly burdened with certain regulatory obligations and costs that are not extended to all other participants in the auction, a competitively-neutral result will not be assured, and the level of compensation determined would not induce efficient market entry.
- Finally, assigning a basic set of COLR requirements on all successful bidders provides greater assurance to regulators that basic telephone services will be provided to all customers, at an acceptable price and quality, over time.

GTE has proposed that recipients of USF funding be required to fulfill their COLR obligations for a period of 3-5 years. A period in excess of one year is necessary to provide service stability and predictability to local subscribers and to give bidders some reasonable expectation of revenue to support necessary investments. On the other hand, the service obligation period should not be excessive so as to deter efficient entry of new competitors willing to assume COLR responsibilities and receive USF support.

A COLR that fulfills its obligation and does not become a COLR in a subsequent period is not forced to cease serving customers in an area. A carrier that does not retain COLR status has a reduced service obligation (e.g., is not required to offer service ubiquitously in an area), can choose the customers it prefers to serve, and will not be subject to any price regulation, but no longer is eligible for USF monies.

Legal Authority

State commissions designate eligible telecommunications carriers under Section 214(e). To be an eligible telecommunications carrier, a carrier must offer the services that are supported by the federal universal service mechanism. See Section 214(e)(1)(A). Eligible telecommunications carriers may only receive universal service funding, "in accordance with Section 254," see Section 214(e)(1), which provides the FCC authority to create a minimum COLR obligation as part of the federal universal service plan. See Sections 254(b)(5), (b)(7).

In addition, Section 254(b)(5) specifies that the federal universal service plan be sufficient to preserve and advance universal service. A plan with asymmetrical requirements for the same support would not result in a "sufficient" plan to meet the requirements of this section.

II. Plan Thresholds and Geographic Boundaries

A. Affordability Threshold

The Joint Board and FCC should establish a monthly rate threshold for the basic service package above which costs to provide such service, on a per customer basis, would be considered high cost and funded by federal and state funds. This Affordability Threshold also will define a maximum rate which customers should be expected to pay for receiving the basic package of universal service.

GTE supports the use of household income to determine this Affordability Threshold. Further, GTE supports the local exchange carrier industry's efforts to refine the methodology for calculating the affordability threshold. It would be appropriate to establish the Affordability Threshold at 1% of household income calculated on a county basis, with a lower bound at one standard deviation from the nationwide median income and an upper bound at one standard deviation.

B. Federal Support Threshold

The FCC, with advice from the Joint Board, should establish a monthly Support Threshold (greater than the Affordability Threshold) above which the costs of providing the basic service package would be covered entirely by the federal jurisdiction. A combination of the state and federal funds could cover the difference between the federal Support Threshold and the Affordability Threshold.

C. Affordability Transition

States should transition local service rates for the basic service package to the Affordability Threshold or cost, whichever is less, or create independent state mechanisms under Section 254(*f*) if the state wants to hold prices below that threshold.

D. Bidding/Geographic Area

The Joint Board and FCC should determine the geographic area upon which the costs of universal service support will be determined (if any) and within which carriers receiving such support will be required to provide service to all customers. The Joint Board must balance the need for plan simplicity with competition issues. Smaller geographic areas — such as Census Block Groups (CBGs) — not only would ease the start-up burden on new entrants, but would maximize the homogeneity of costs faced by incumbents already operating in these areas. Otherwise stated, smaller areas would limit the variation of costs faced by carriers; larger areas, such as wire centers, would mix lower-cost town centers with significantly higher-cost outlying areas.

GTE proposes CBGs as the best choice of geographic unit. The selection of the area and auction structure will affect the degree to which targeting of support can be achieved. CBGs can be subdivided when necessary to accommodate existing service areas and to improve targeting of support.

E. Income-based Assistance

Individuals eligible for income-based support can request local service from any carrier operating locally. Customer eligibility would be determined by a customer's participation in a federal or state income assistance program. Self certification should not be employed.

Carriers need not be eligible telecommunications carriers or carriers of last resort for this purpose. Carriers will credit customers' accounts with the income-based support amount for each eligible customer served. This program can accommodate existing federal "Link-Up" and "Lifeline" mechanisms. The FCC and states can review periodically the amount of support provided under this program to determine the need for adjustments. This program should not be tied to the existing interstate SLC, since only incumbent LECs assess such a charge.

Policy Rationale

A universal service plan should be based on market principles. The plan should expose customers to a reasonable price for universal service, while intervening to hold down that price in high-cost areas. This would provide carriers with sufficient support to offer a market rate for their services. Currently, high cost assistance programs are not directly linked to local service prices. Support provided to carriers is based on a formula which considers average costs, with the remainder of any support needed coming from prices for other services or to other customers charged, which also reflect average costs. Properly established thresholds would send market price signals to both customers and carriers entering the market.

Legal Authority

The FCC must ensure that quality universal services are available at affordable rates. Section 254(b)(1). States may designate service areas as they choose for all areas except those served by rural telephone companies. The 1996 Act designates these as study areas until the FCC and states change them in conjunction with a recommendation from the Joint Board. The 1996 Act limits the availability of universal service funding, however, to eligible telecommunications carriers that offer universal service "in accordance with Section 254." Section 214(e)(1). Thus, the FCC could adopt small bidding areas as part of its authority to devise a comprehensive universal service support mechanism. See Sections 254(b)(5), (b)(7).

III. Support Calculation

Initial universal service support should be determined by comparing the actual costs of providing a basic universal service package with the Affordability Threshold selected by the Joint Board. Carriers, for which the per customer cost of providing universal service is greater than the Affordability Threshold, would receive support for the amount over the Affordability Threshold for each customer served in a given area. Once the initial cost-based level is established, the level of support should be subject to competitive bidding. Carriers would bid on the level of support they needed to provide universal service in a given market when constrained by an Affordability Threshold and other carrier obligations outlined above.

In the context of competitive bidding, it is useful to distinguish between the calculation of support provided to incumbent carriers prior to any requests for competitive bidding and the determination of support under a competitive bidding process. The following, therefore, distinguishes between "Day 1" when the new universal service explicit funding mechanism is established and "Day 2+" when carriers determine support through the competitive bidding process.

A. Step 1

1. The actual costs experienced by an Incumbent LEC are either calculated for each geographic area (Census Block Group) or are assigned to CBGs from a higher level of aggregation (e.g. study area) through the use of relative cost estimation models. If a carrier can determine actual costs on a CBG basis, they can directly assign those costs without the use of a cost estimation model.

2. For each customer served, a carrier would receive support for the difference between the Affordability Threshold and the per customer, actual cost within each CBG.

3. Where the rate charged to customers exceeds the Affordability Threshold or cost, the rate should transition down to the threshold or cost, whichever is less.

B. Step 2* (Unique to Auction Proposal)

1. Entrants notify a state commission of their intent to bid for the opportunity to provide universal service as a carrier of last resort and to receive funding at a level determined by the competitive bidding process.

2. States would conduct auctions at regular intervals, initially twice each year on a fixed date. Each scheduled auction would include those market areas designated for auction by new entrants. Once auctioned, a CBG would not be subject to auction again until the expiration of the term commitment for winning carriers of last resort.

3. Upon determination of auction winners, funding is provided to all "winners" for each customer served based on the winning bid.

Policy Rationale

Especially with the use of a competitive bidding mechanism, it is entirely appropriate to initiate a new explicit universal service funding mechanism at today's actual cost of providing service. The only actual cost experience in providing such services is captured in the reported costs of existing incumbent local exchange carriers. Thus, it is a reasonable starting point, with the auction mechanism to adjust support requirements to competitive market levels. Relying instead on cost proxy estimates could deter competitive entry (not enough support for new entrants) while under-compensating existing carriers.

Once completed, auctions could then be scheduled for each market upon completion of the COLR term of service. These subsequent auctions would permit adjustments to the support required for universal service, taking into account the addition of advanced services to the basic universal service definition, changes in technology, and cost structures. Without competitive bidding, regulators would be forced into an endless cycle of re-estimating costs to account for these changes.

Legal Authority

The FCC has the authority to adopt a universal service support mechanism as long as it is "specific, predictable, and sufficient." Section 254(b)5). GTE's auction proposal is predictable because it sets specific parameters for the auction process, and it sets a defined period for the COLR obligation. In addition, the GTE universal service support plan is specific and sufficient because it is comprehensive, it accounts for universal service support both before and after the emergence of competition, and it can be applied to all areas in which universal service support is necessary. An auction also would result in presumptively sufficient funding because the service provider would be specifying what they believe to be a sufficient amount in their bid.

IV. Distribution of Funding

The distribution of funding to carriers will first be determined by geography, with each CBG being assigned funding for the amount that the cost of serving each subscriber exceeds the affordability threshold, totaled across all subscribers in the area. Following an auction for a given geographic area, the support would be based on the winning bid. Any carrier operating as a carrier of last resort (and among the winning bidders when auctions are held) receives fund support for each customer served.

Policy Rationale

Funding of universal service should be efficient, sufficient, and simple. GTE's proposed auction mechanism and support mechanism would accomplish these goals. Funding provided on a per customer basis to each carrier will ensure competitive neutrality and an equitable distribution of funding support. Coupled with symmetrical carrier obligations, this funding method will encourage competition, not on the basis of different obligations or funding eligibility, but on price, service quality, and other service attributes.

Legal Authority

Under the 1996 Act, universal service support "should be explicit and sufficient to achieve the purposes of [Section 254]." Section 254(e). This distribution of funding ensures this result.

V. Funding Sources

A national plan with shared federal and state responsibility should be strongly considered. In such a plan, federal funding would:

- Cover those costs above a federal Support Threshold that is set higher than the Affordability Threshold.
- Share funding support for income-based assistance programs.
- Fund the difference between current local monthly rates and the Affordability Threshold, in diminishing amounts; this would encourage states to eliminate disparities between current rates and the Affordability Threshold.

Meanwhile, the state fund would:

- Cover the difference between the federal Support Threshold and the Affordability Threshold.
- Cover the difference during a transition between the Affordability Threshold and initial price (price on Day 1), if it is lower. This transitional support would diminish as the initial price moved to the Affordability Threshold or cost, whichever is less.

States are free to fund any additional universal service requirements they deem appropriate within their jurisdictions.

One major advantage of federal and state regulators sharing responsibility for the plan is the ability for each to link the plan implementation to the development of rational rate structures in their respective jurisdictions.

Whether a federal fund or a state fund, support requirements should be raised using a uniform surcharge on the telecom retail revenues of all service providers. The FCC may impose a uniform surcharge on all telecom retail revenues of carriers which provide interstate service, to any extent. States may impose a uniform surcharge on the intrastate telecom retail revenues of carriers providing intrastate service. Because it is difficult to determine intrastate revenue for interexchange carriers, it may be desirable for states to also place a surcharge on all telecom retail revenues billed in the state. If states were authorized to do so as part of a federally-ordered plan, potential legal and jurisdictional issues may be resolved.

Policy Rationale

A uniform surcharge applied to retail revenues will result in an explicit and competitively neutral funding mechanism. Customers, faced with uniform surcharges on telecom retail services of all carriers, will not have the incentive to switch from one carrier or service to another merely because of surcharge amounts. A uniform surcharge also is the simplest mechanism.

The use of gross revenues will skew the burden of funding to carriers which receive a significant amount of carrier revenue, such as access charges. The use of gross revenues net of carrier payments is more complicated and could result in uneven burdens depending on the degree to which certain services are subject to a surcharge including wholesale resale charges, access charges, and unbundled elements. Predictable and efficient support necessary to meet the objectives of universal service is best met by a uniform surcharge on the telecom retail revenues of all carriers.

Legal Authority

The 1996 Act requires "every telecommunications carrier that provides interstate telecommunications service" to contribute, "on an equitable and nondiscriminatory basis," to the support mechanism that the FCC establishes to preserve universal service. Section 254(d). "Every telecommunications carrier that provides intrastate telecommunications services" shall contribute, "on an equitable and nondiscriminatory basis" to state mechanisms to support universal service. Section 254(f).

VI. Offsetting Rate Reductions

Since universal service will be funded by an explicit program, any increase in the explicit support received by incumbent carriers at the outset of the program should be offset by price reductions of other services, which currently provide implicit support, on a revenue-neutral basis. Revenue offsets should be applied to those incumbent LEC services which bear the greatest amount of implicit support, both interstate and state, not to any single rate element. Interstate reductions should be applied to the carrier common line, the residual interconnection charge, and the subscriber line charge. Funds from the federal fund also should be used to offset those state rates which currently provide implicit support.

Policy Rationale

Off-setting rate reductions are required to ensure that incumbent LECs are not over-compensated with explicit universal service funding. These rate offsets are especially important given the FCC's recent interconnection order. The more focused the offset on implicit support-bearing services such as access, the closer the rates can be set to the prices of unbundled elements which comprise access services. One of the logical outcomes of the national pro-competitive policy is that prices would more closely resemble costs.

Legal Authority

The Act requires funding for universal service through explicit, rather than implicit, support. See H. R. Conf. Rep. No. 458, 104th Cong., 2d Sess. 131 (1996). In addition, the FCC in its Interconnection Order made clear that it would not permit the recovery of universal service support through rates charged for services and elements available under Section 251. Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, First Report and Order, CC Docket No. 96-98, FCC No. 96-325 at para. 712 (released August 8, 1996) ("Interconnection Order"). However, the Commission maintained that ILECs should continue to recover certain non-cost-based interstate access charge revenues for a limited time to avoid harming universal service. Id at para. 715.

While Congress created distinct obligations for ILECs to unbundle network elements and resell local service in its entirety, See Section 251(c)(3),(c)(4), the Commission extended these obligations to permit new entrants without any facilities to take advantage of either method, permitting the combination of all unbundled elements to offer complete telecommunications services, including exchange access services. Interconnection Order at para. 329-333.

At the same time, the Commission has also determined that when ILECs resell local service pursuant to Section 251(c)(4), the 1996 Act requires that ILECs continue to receive access charge revenues. Id. At para. 980. However, with respect to unbundled network elements, the Commission determined that telecommunications carriers purchasing unbundled network elements to provide local and exchange access services are not required to pay federal or state exchange access charges, except for the carrier common line charge and a charge equal to 75% of the transport interconnection charge until the earliest of 1) June 30, 1997; 2) final FCC decision on universal service and access reform; or 3) if the ILEC is a BOC authorized under Section 271 to provide in-region interLATA service. Id. at para. 720.

Thus, because the Commission has created the opportunity for new entrants to bypass some level of access charges in the interim, and all access charges within less than a year, through the purchase of unbundled elements, ILECs need to be able to implement offsetting reductions in rates for services that bear implicit support to remain competitive.

VII. Auction Mechanism

Competitive bidding can be used to introduce a competitive market mechanism into a traditionally closed system of universal service funding. Auctions can determine the amount of support received by a carrier willing to meet certain obligations. Auctions are far likelier to result in a reasonable and competitively-neutral result than would cost estimation models. However, auctions will not work unless carriers have something to win and if they run a risk in winning it. Only winners would be permitted to receive universal service funding. But, all qualified carriers, including incumbent LECs, would have the opportunity to lose or withdraw.

A. Notification Mechanism

State commissions should conduct auctions twice each year initially. Carriers may notify states 90 days in advance of each auction date as to the Census Block Group(s) on which they intend to bid. This notification will place those identified markets into the next auction round. Once a market has been subject to a completed auction, it will not be re-bid until the carrier of last resort's obligation and a minimum auction interval have been achieved.

B. Auction Design Principles

1. The winning number of carriers must be balanced against the amount of support required to fund those carriers in a given market.
2. All winners should receive the same level of support.
3. Complicated auction designs should be ruled out given the use of small Census Block Group geographic areas.
4. Collusion should be guarded against, especially in the event of only two interested bidders.
5. Bidder qualifications are important to consider in advance of an auction, given that bidders are assuming an obligation in exchange for support payments.

C. Auction Objectives

1. Encourage competition both "in the market" and "for the market" to encourage carriers to provide innovative and quality services to consumers.
2. Have the "winners" be the carriers for whom the actual cost of providing service is lowest or who are willing to provide service for the lowest level of support.
3. Constrain the amount of support payments required.

D. Auction Mechanism - One Proposal

1. Incorporate notification mechanism (above.)
2. State commissions establish a maximum support rate based on some multiple above actual, estimated cost in order to accommodate situations where the initial costs are under-estimated. Excessively low limits would discourage others from considering entry.